Inflation and The Public Sector

Ontario

STATEMENT BY

The Honourable

John White

Treasurer of Ontario and
Minister of Economics and Intergovernmental Affairs

...ting of the Ministers of Finance

..., JANUARY 24 - 25, 1974

TABLE OF CONTENTS

INFLATION AND THE PUBLIC SECTOR

Mr. Chairman:

It is a pleasure to meet you and our counterparts from the other provinces to discuss the economic and fiscal outlook for Canada. There are important matters to be considered and I look forward to a constructive meeting. The uncertainty concerning worldwide inflationary pressures and energy shortages makes it necessary to seek and set policies which will be beneficial to the Canadian economy and which will contribute to better control of expenditure in the public sector.

I should like first to review the environment for economic policy before examining important developments for public sector planning and intergovernmental finance in Canada.

Economic Policy Environment

The Canadian economy advanced strongly in 1973. This growth has been accompanied by a rapid rate of inflation, however, as supply shortages have become acute. The difficulties of maintaining a growth rate commensurate with potential have been compounded by reduced energy supplies to the major industrial countries, and by the escalation of international oil prices. We have moved from a period of excess capacity and high unemployment to a period of supply

shortages and rapidly rising prices. I think we have witnessed also a fundamental change in the attitude of the federal government towards inflation. Perhaps mindful of the adverse effects on economic growth and employment of its deflationary monetary and fiscal policies in 1970, the federal government appears willing to allow inflation to run its course without any broadly-based strategy to stabilize the price level.

While it is true that we are vulnerable to external inflationary influences and may therefore be forced to accommodate higher rates of inflation than usual, we must never accept the presence of inflation nor resign ourselves to it. The federal government and the provinces have moved to moderate some of the effects of inflation by indexing the personal income tax, family allowances and pensions. These measures are helpful, but they cannot provide full protection to many people. In addition they do nothing to get at the root of domestic inflationary forces, to remove supply bottlenecks, to improve the allocation of resources, or to provide for better balance of revenues and expenditures in the public sector.

The outlook for inflation in Ontario and elsewhere is dominated by considerations of the recent dramatic changes in oil prices. These developments

have serious implications for inflation, but even without increased energy costs, price advances in 1974 would have continued at a disturbingly high rate. Indeed, we seem to be entering a fundamentally new kind of inflationary situation, which is secular rather than cyclical in nature, and which requires bold new economic policies. I anticipate that inflation in 1974 will continue at least as strongly as in 1973. I expect that the Consumer Price Index could advance by 10 per cent or more in 1974, while the general GNE deflator could rise by 6 to 7 per cent over the 1973 level.

With these considerations in mind, I directed my officials to submit a list of crucial questions to the recent meeting of the Continuing Committee on Economic and Fiscal Matters. I thought we might usefully discuss these questions later today. In our discussions I think it is important that we acknowledge the contribution of the public sector to inflation. We should discuss federal monetary and fiscal policy and the implications for public sector growth. We should examine the cash requirements and borrowing needs of government in light of the large capital demands of the private sector, and discuss the implications for debt management. We should discuss the outlook for government revenues and expenditures in 1974.

Examination of these questions necessitates analysis of the federal and provincial-municipal sector finances. I should now like to review the financial position of the federal government before proceeding to the provincial-municipal outlook.

Federal Government Finances

During the debate on national tax reform, Ontario quantified the massive revenue gains which would accrue to the federal government under its original white paper proposals.[1] While the reforms the federal government introduced have differed from its original proposals, the results are similar. Certainly under the new tax system the major result has been substantially increased federal revenue capacity. This in turn has allowed the federal government to finance a series of tax cuts and expenditure increases in order to avoid the huge and embarrassing surpluses which otherwise would have occurred.

At last year's Meeting of Ministers of Finance I stressed the need for redistribution of tax resources to the provinces in order to avoid provincial and

---

1 Ontario's views on federal-provincial tax reform were developed in Hon. C. S. MacNaughton, Ontario Proposals for Tax Reform in Canada, and Staff Papers, Analysis of Federal Tax Reform Proposals, and Tax Reform and Revenue Growth to 1980, Ontario studies in Tax Reform 2 and 4, (Toronto: Department of Treasury and Economics, 1970 and 1971).

municipal tax increases, cuts in essential public services and uncoordinated growth of the public sector. At the same time, I urged a permanent tax cut by the federal government for the purpose of stimulating economic growth and employment.[2] I also recommended that a change in tax-sharing arrangements be worked out to allow the provinces to utilize part of the tax room made available by such a withdrawal.

As I have noted the federal government did subsequently introduce a sizeable cut in personal income taxes and expenditure increases.

Let me list some of these federal initiatives:

- a $1 billion payment in 1973 to offset the unemployment insurance deficit;
- an $800 million annual increase in family allowances;
- a $1.3 billion annual reduction in personal income taxes;
- a $600-$700 million reduction annually in corporate tax (when fully effective) for the manufacturing and processing industries; and
- a $400-$500 million personal income tax reduction from indexing in 1974 (increasing substantially in subsequent years).

---

2 Hon. John White, Fiscal Policy Management and Tax-Sharing Reform, Statement to Ministers of Finance, Ottawa, January 18-19, 1973.

This list adds up to a figure of more than $3.0 billion a year, excluding the payment to cover the deficit of the Unemployment Insurance Fund.

Yet even after all the tax reductions, federal gross general revenues will likely increase by about 19 per cent in 1974-75. After inflation indexing, federal personal income taxes will probably increase by more than 25 per cent. Total revenue growth for all provinces, on the other hand, will likely average about 10 per cent in 1974-75. Mr. Chairman, I do not say that all of the measures which you have taken are unwarranted. But surely this comparison is evidence that the federal government has neglected the financial plight of the provinces and the municipalities.

What is the provincial-municipal sector to do in this situation? Are their taxes to be raised? If so I suggest that it cannot be done fairly and responsibly. Use of the income tax would counteract the benefits of federal income tax cuts, while greater use of sales and property taxes would represent a further departure from the ability-to-pay objective of comprehensive tax reform. In addition, are we to engage in high levels of borrowing at a time when interest rates are reaching record highs? If so, there would be dramatic increases in the share of revenues allocated to interest payments, leaving less of our scarce financial resources for essential public services.

Public Sector Growth in Canada

The rapid growth of federal revenues has resulted in a substantial increase in the federal share of the economy. On a national accounts basis, federal government expenditures, as a percentage of GNP, have increased from 17.5 per cent in 1970 to 18.8 per cent in 1973. Provincial-municipal expenditures, on the other hand, which rose strongly in 1971 as expansionary fiscal policies were introduced, have declined from a high of 22.4 per cent to 21.3 per cent of GNP.

Government Expenditure as a Per Cent of
Gross National Product (GNP)
(National accounts basis)

	1970	1971	1972	1973[1]
Federal	17.5	18.3	19.1	18.8
Provincial-Municipal	21.2	22.4	22.1	21.3

Source: Statistics Canada.

1. First three quarters.

This rapid growth of the federal government sector has implications for the growth of the public sector as a whole. In its Ninth and Tenth Annual Reviews the Economic Council recommended reduced expenditure growth in the public

sector.[3] I agree with this recommendation. The precondition for limiting growth in the public sector is that the federal government curtail its inordinate expenditure growth and transfer revenue resources to permit tax stabilization in the provincial-municipal sector.

Had the federal government in recent years transferred to the provinces sufficient tax room to minimize their deficits under national tax reform, the federal sector would not have grown so dramatically and there would be considerably less inflationary bias in the Canadian economy today.

The Economic Council has recommended also that federal and provincial governments should co-ordinate their economic policies by establishing targets for expenditure growth, preferably in co-operation with the Council itself. I support this initiative and urge our serious consideration of this suggestion at this meeting. While the effective planning and co-ordination of federal-provincial economic policies is still in the early stages of development, we must move forward more agressively from now on. That this can be accomplished is evidenced by the increased co-ordination achieved in the provincial-municipal area in Ontario.

---

[3] Economic Council of Canada, The Years to 1980, Ninth Annual Review and Shaping the Expansion, Tenth Annual Review (Ottawa: Queen's Printer, 1972 and 1973).

Provincial-Municipal Finances

While federal revenue growth remains strong and the federal presence in the economy expands, the provincial-municipal sector is experiencing adverse pressure on its revenues coupled with new expenditure demands in provincial-municipal areas such as housing, transportation, urban and regional development, energy and the environment. The increasing deficits in the provincial-municipal sector clearly demonstrate the imbalance in the revenue and expenditure positions of the three levels of government in Canada.

This situation is aggravated by:

- indexing of the personal income tax;
- reduced growth in federal transfers under shared-cost programs; and
- uncertainty regarding the level and timing of compensation under tax reform and subsequent changes.

Indexing is to be welcomed from the point of view of compensating taxpayers for losses in real incomes resulting from inflation. The staff study which I am tabling today shows a strong adverse effect on provincial revenue growth, however.[4] For example, assuming a sustained rate of inflation of 6 per cent annually and real growth in Gross National Product (GNP) of 5 1/2 per cent, federal indexing will reduce Ontario's revenue growth from the personal income tax by about $65 million in 1974.

---

4 Staff Paper, The Dynamic Impact of Indexing the Personal Income Tax, Ontario Tax Studies 9 (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, January, 1974).

By 1977, this revenue loss will rise to $350 million. I should like to add that we tabled estimates of the effects of indexing at the meeting of the Continuing Committe of Officials on Indexing last November, and presented more refined estimates at the Committee's meeting earlier this month. The latter analysis included estimates of the revenue impact of indexing for seven other provinces which were developed with their cooperation. One of the major conclusions of the study was that the experience for Ontario applies generally for all provinces with tax collection agreements with Ottawa. Micro-simulation of the revenue structures of other provinces confirms that the indexing losses will be relatively greater in the low income provinces. I have attached two tables detailing the revenue losses to Ontario and the other provinces.

Secondly, reduced growth in federal transfer payments in health, welfare, education and other shared-cost fields has provided the federal government with significant flexibility to redeploy these funds to finance new expenditure programs. Had the provinces received tax-point equivalents as earlier suggested by Alberta, Quebec and Ontario they would now be benefitting from the de-escalation in costs in these areas.

And thirdly, the provinces that are integrated into the federal income tax system face considerable uncertainty regarding compensation for unilateral federal actions.

The level and timing of payments under the federal Revenue Guarantee are uncertain. In addition, although certain post-reform tax changes are included in the Guarantee (e.g. the change in personal exemptions and corporation tax incentives for the manufacturing and processing industries), indexing losses are not included. Why not? Is this not inconsistent?

Ontario's Financial Position

Great pressures will be exerted on Ontario's financial position during the next decade. Our population is concentrated in major urban centres and with increasingly rapid urbanization, new provincial-municipal expenditures will be needed in areas such as housing and mass transit. In addition, the importance of manufacturing in the Ontario economy means rapidly increasing energy demands. These are areas where inflation will likely be highest. Our constrained revenue base emanating from tax reform, indexing and a slowdown in federal transfers cannot finance these priority needs. Neither can increased use of the capital market.

For fiscal 1973-74, Ontario's gross budgetary revenues will have increased by about 11 per cent. In fiscal 1974-75 I anticipate gross budgetary revenues will advance by 8-9 per cent, while under the impact of inflation gross budgetary expenditures including transfers may advance by

11-12 per cent. As a result, Ontario's deficit could increase by some $200 million. Consequently, our total cash requirements could be close to 20 per cent of our gross general revenues. A different picture emerges, however, when viewing the federal government's financial prospects. Even without revenues from the oil tax, federal cash requirements will likely be lower relative to gross general revenues in 1974-75.

I realize, of course, that increases in the price of oil will generate substantial revenue flows from the non-oil producing provinces and the consumer sector to the producing provinces and the federal government. This situation complicates the financial outlook, for these revenue flows have broad implications for economic activity and intergovernmental finance in Canada. They will exacerbate inflation, dampen real growth in eastern provinces and fundamentally alter the distribution of financial resources among the various provinces.

FEDERAL AND ONTARIO DIRECT CASH REQUIREMENTS AS A PER CENT OF GROSS GENERAL REVENUES 1971-72 to 1974-75

	1971-72	1972-73	1973-74	1974-75
Federal Cash Requirements[1] ($ Billion)	1.5	1.5	2.0	1.8
Per Cent of Gross General Revenue	8.7%	7.1%	8.7%	6.5%
Ontario Cash Requirements[2] ($ Billion)	1.1	0.9	1.3	1.5
Per Cent of Gross General Revenue[3]	19.9%	14.6%	18.4%	19.0%

Source: Ontario Treasury estimates.

Notes 1: Excluding foreign exchange requirements.

2: Including borrowing by the Province on behalf of Ontario Hydro and other government enterprises.

3: Gross General Revenue includes revenues from Workmen's Compensation Board and other social insurance funds.

Ontario's Municipal Revenue-Sharing Policy

I should now like to elaborate on Ontario's revenue sharing policy. In Ontario, municipal tax resources have not been sufficient to pay the costs of existing levels of service. The crux of the financing problem for local government is this: municipal levies grow at 4-5 per cent each year without rate increases, while existing municipal spending responsibilities grow at 10-12 per cent per year. In particular, property taxes have a very low growth rate. As an integral part of Ontario's own tax reform program the Government of Ontario has sought to reduce property taxes through the Property Tax Stabilization Plan and to minimize the regressivity of the property tax through property tax credits deductible from income tax. Ontario has demonstrated its concern for local government needs by transferring an important share of its revenues to the local sector.

The magnitude of our effort in this direction is shown by the fact that provincial assistance, as a percentage of local revenue, grew from 41.5 per cent in 1970 to 49.9 per cent in 1973. Total provincial funding now amounts to more than $2.4 billion and equals about 90 per cent of our total revenues from the personal income tax and retail sales tax.

Despite increases in provincial grants to municipalities, the municipal sector in Ontario still faces a growing deficit position during the coming years. On the basis of current trends I expect annual municipal deficits could well increase to $500 million in three years.

At the National Tri-Level Conference, I made a commitment to the municipalities of Ontario to enlarge their financial base by transferring provincial funds to local government.[5] My overall policy can be summarized as follows:

(1) Ontario's financial transfers to local government will be increased at the rate of its total revenues;

(2) municipal borrowing capabilities will be strengthened; and

(3) increased federal tax sharing will be delivered to local governments, dollar for dollar.

Financing New Priorities

There will be heavy demands on the Canadian capital market during the next decade reflecting massive long-term investments in such fields as energy, housing and transportation. To the extent that the provinces and municipalities do not obtain adequate revenue-sharing with Ottawa, the lower levels of government will have to rely increasingly

---

5 Hon. John White, Public Finance, a Position Paper presented to the National Tri-Level Conference, Edmonton, October 22-23, 1973.

on the long-term capital markets to finance their expenditure program. If there are high rates of inflation during the coming period there will be strong upward pressure on interest rates and greatly increased costs of servicing the public debt, thus putting an added strain on their financial positions.

There are three basic interrelated approaches to accommodating or financing the new expenditure priorities of the provinces and municipalities:

(1) a new deal in revenue sharing;

(2) tax increases; and

(3) long-term borrowing in domestic and foreign markets.

I have recommended that reliance be placed on revenue sharing to avoid imposing additional financial burdens on taxpayers and to control the overall deficit positions of the provinces and municipalities. Borrowing is not a satisfactory long-run solution to the financial problems of the municipalities, although some additional scope does exist for this type of financing. In Ontario, amounts of money borrowed by municipalities have been relatively stable during the past two years. Ontario municipalities could expand their financial resources by increased borrowing but municipalities would also pay higher interest charges than other levels of government. Consequently, it is important that the senior level of government, and in particular the federal government, assumes an appropriate share of public sector indebtedness. Here again, we point out that the federal government has not fulfilled its

primary role in using this economic instrument.

These measures would assist the municipalities but I emphasize that they cannot remedy their basic financial problem. Mr. Chairman, as I stated in Edmonton, the only lasting solution is an increase in unconditional transfers to the Province which I have agreed to pass on to the municipalities dollar for dollar.

Conclusion

Mr. Chairman, the federal government has not met the urgent need for a new deal in revenue sharing which has been consistently documented since 1966. It has returned to taxpayers some part of the massive revenue gains accruing from tax reform but it has also engaged in a spending spree of unprecedented proportions. The federal government has done nothing to improve the long-run financial position of the provincial-municipal sector where the real financing need exists and the real expenditure pressures lie.

I have made a revenue-sharing commitment to our municipalities. It now rests with the federal government to provide the provincial-municipal sector in Ontario with

a fair share of the growth potential of total revenues generated in the Province. If the financial problems of the provincial-municipal sector are ignored, substantial increases in the regressive property taxes at the local level will be unavoidable. It will be abundantly clear to the municipalities and their representatives, some of whom are here today, that increasing property taxes are the result of inaction by the federal government.

Unless the federal government is prepared to change its policy, I foresee a serious deterioration in intergovernmental fiscal cooperation and an increase in uncoordinated tax policies. This in turn will make ineffective the use of fiscal instruments for economic policy implementation.

Let us agree at this meeting to two things. First, to decide upon a new revenue-sharing arrangement. And second, to accept the recommendation of the Economic Council of Canada to examine expenditure targets for the public sector in Canada. If we do these two things, we can control the growth of the government sector, we can reduce inflation, and we can ensure a more harmonized and more equitable tax system in Canada.

Thank you.

APPENDICES

Appendix 1: Ontario's Questions Concerning Federal Fiscal, Monetary and Economic Policy in 1974.

Appendix 2: Percentage Reduction in Ontario's Personal Income Tax Revenues Arising from Indexing.

Appendix 3: Summary of the Impact of Indexing on Provincial Personal Income Tax Revenues.

Appendix 1

ONTARIO'S QUESTIONS CONCERNING FEDERAL FISCAL, MONETARY AND ECONOMIC POLICY IN 1974 *

1. What are the federal government's economic targets for 1974 in terms of real economic growth, employment and prices? In particular, what impact will the energy situation have on economic growth in various regions of the country?

2. What strategy does the federal government have to control inflation in 1974 and beyond?

3. On what basis does the federal government intend to prioritize available fuel supplies so as to maintain economic growth in all regions of Canada?

4. Does the federal government have a strategy to deal with widespread commodity and materials shortages which threaten the nation's growth potential for 1974?

5. What fiscal policy stance should the total government sector in Canada adopt and what kind of balance of taxing, spending and borrowing will be most appropriate between the three levels of government?

6. What is the federal government's forecast of aggregate domestic supply and demand for funds in 1974?

7. What is the 1974 outlook for interest rates?

8. Does the federal government foresee a major shift of corporate borrowing away from bank loans into the long bond market in 1974?

9. Is the federal government planning to reduce its reliance on C.S.B.'s in 1974 and to enter the domestic long bond market? Also, does it plan to borrow abroad so as to share with the provinces some of the exchange rate risks of foreign borrowing?

10. What will be the federal government's attitude towards borrowing abroad by the provinces if domestic capital market conditions prove to be unfavourable?

---

* Tabled at the Meeting of the Continuing Committee of Officials on Economic and Fiscal Matters, January 7-8, 1974, in preparation for the Ministers of Finance Meeting, Ottawa, January 24-25, 1974.

Appendix 2

PERCENTAGE REDUCTION IN ONTARIO'S PERSONAL INCOME TAX REVENUES ARISING FROM INDEXING

Rate of Inflation	Indexing loss as a per cent of pre-indexed P.I.T. revenues			
	1974	1975	1977	1980
5%	3.9	6.7	11.8	17.7
6%	3.9	7.0	13.0	19.8
7%	3.9	7.4	14.2	21.7
8%	3.9	7.7	15.3	23.4

Source: Staff Paper, The Dynamic Impact of Indexing the Personal Income Tax, Ontario's Tax Studies 9 (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, January, 1974).

Appendix 3

SUMMARY OF THE IMPACT OF INDEXING
ON PROVINCIAL PERSONAL INCOME TAX REVENUES

	Percentage Reduction			
	1974	1975	1976	1977
Newfoundland	5.2	9.2	13.2	16.4
New Brunswick	5.0	8.8	12.7	15.9
Nova Scotia	4.8	8.5	12.3	15.4
Ontario	3.9	7.0	10.3	13.0
Manitoba	4.4	7.9	11.5	14.4
Saskatchewan	4.8	8.6	12.5	15.7
Alberta	4.2	7.5	10.9	13.8
British Columbia	3.6	6.4	9.4	12.0

Source: Ontario Tax Studies 9, see Appendix 2.

Notes 1. Figures are the results of processing Green Book samples for each province for the 1972 tax year.

2. The appropriate Personal Income Tax rate for each province has been used; further family allowances were paid (and indexed) at the rate of $240/child/month.

3. Rates of inflation used are:
   1974 - 6.6%
   1975 - 6.0%
   1976 - 6.0%
   1977 - 6.0%